I. INTRODUCTION

Risk management, which includes insurance management, is intended to minimize the cost associated with certain types of risk and provide prudent protection. It deals with pure risks that are characterized by chance occurrence and may only result in a financial loss as opposed to a speculative risk which affords the opportunity for financial gain or loss. Such pure risks are separated into three major exposure categories: property, liability and personnel.

There are three stages in the risk management process; risk identification and analysis, risk control, and risk treatment. Identification and analysis requires a review of all aspects of the bank's present and prospective operations to determine where the bank is exposed to loss, including consultation with a reliable insurance professional. Risk control is primarily dependent upon the strength of the bank's internal controls, policies and procedures. Risk treatment refers to choosing the appropriate steps or methods to deal with a particular risk. The objective of this process is to minimize the costs associated with pure risks, such as direct costs of loss prevention measures, insurance premiums, losses sustained, and related administrative expenses. A bank has several options in treating a particular risk. It can implement additional controls to minimize yet retain the risk (i.e., become a self- insurer), transfer the risk to another party through insurance or contractual transfer, or a combination of these. A basic tenet of risk management is that those risks which carry the potential for catastrophic or significant loss should not be retained if avoidable. Conversely, it is not cost justified to insure losses which are relatively predictable and not severe. The board of directors must determine the maximum loss the bank is able and willing to assume, and should at least perform an annual review of the bank's risk and insurance management program.

The real value of insurance lies in the protection it affords against catastrophic losses. To the extent a bank does not have adequate coverage, losses deplete capital and impair the position of depositors and the FDIC. Examiner review and analysis of the adequacy of the bank's insurance program is clearly necessary. The various types of insurance coverages (delineated below) serve only as a guide and a reference of available insurance protection. The specific needs of a bank must be determined on an individual basis, and only by reviewing each policy in force, can the actual degree of coverage and protection be determined. Any material inadequacies of insurance coverage should be directed to management's attention. Lack of any significant coverage, board of director approval and review, or deficiencies in a bank's loss prevention program should be appropriately commented upon in the report of examination.

II. FIDELITY INSURANCE PROTECTION

Fidelity insurance protection is appropriate for all banks because it insures certain risks that contain the potential for significant loss. Section 18(e) of the Federal Deposit Insurance Act provides that the FDIC may require such coverage, and if not complied with, may contract for such protection and add the cost thereof to the bank's deposit insurance assessment. However, such action would only be taken in rare instances, such as when a bank is able to obtain protection but refuses to do so.

If the bank is without coverage, a thorough investigation should be made to determine the reasons therefor. These banks must continue diligent, good faith efforts to obtain reasonably priced coverage. Their efforts should be monitored periodically to confirm the actions being taken to obtain coverage, including steps necessary to satisfy any conditions that may have been imposed by an insurer as a prerequisite for coverage.

In some cases, a bank may offer alternate arrangements in lieu of the usual insurance bond. While it is difficult to generalize, these arrangements (e.g., having directors or owners sign personal guarantees or increasing the bank's capital) do not protect the bank against the same risks in essentially the same manner or to the same extent, and therefore are generally not acceptable as substitutes for insurance coverage. However, each such offer should be appraised on its merits for whatever additional protection it might provide in the interim.

While a periodic review of internal and external security measures and controls is appropriate in every bank, it is especially appropriate in a bank that is operating without fidelity insurance coverage. Ideally, this effort should be undertaken as a special project with responsibility fixed in a particular executive officer and should include a thoroughgoing review of the bank's existing programs, the design and implementation of additional security procedures and controls, and a formal report to the board of directors which should note its action on the report in the minutes of the meeting. Management should also consider the use of outside experts as necessary to assist it in strengthening its programs or possibly to help the bank qualify for fidelity protection where a carrier has previously cited specific deficiencies that require correction.

Providing Examination Information to an Insurance Carrier

On occasion, a bank may inquire about permission to release an examination report or information from such report to an insurance carrier. These inquiries should be discouraged. A bank should be able to demonstrate its insurability to prospective insurers without having to release confidential information from an FDIC examination report. Adequate information is available from the bank's records and from nonconfidential sources to enable an insurer to accurately assess its underwriting risk.

Protection From Both External and Internal Hazards

External hazard includes the possibility of dishonest, fraudulent, and criminal acts committed against the bank and its employees by the general public. Robbery, burglary, and forgery are the predominate acts. Banks endeavor to guard against losses from these sources by maintaining vaults and safes, reliable alarm systems, and other security devices which should, at a minimum, meet the requirements set forth in Part 326 of the FDIC's Rules and Regulations. Banks should also attempt to limit the size of such losses by keeping exposed cash and negotiable securities at a minimum. Internal hazard, which is far greater, deals with the possibility of defalcations by the bank's own personnel. Banks should try to protect themselves against this hazard by maintaining clear records and effective systems of internal routine and controls.

Bankers Blanket Bond Insurance

Although the policy may be modified from time to time, it is not uncommon for a blanket bond policy to be issued and carry an expiration date which is not pertinent. Review of invoices and mode of payment is necessary to determine the actual expiration date of coverage. An appropriate written waiver from the insurance company should be in evidence for any individual who has been granted consent to serve as a director, officer or employee pursuant to Section 19 of the FDI Act.

The most common form of blanket bonds used by commercial and savings banks is the Financial Institution Bond, Standard Form No. 24. Other forms may be encountered and should be thoroughly analyzed to determine the extent of coverage. Standard Form No. 24 has two different limits of liability -- a single loss limit of liability and an aggregate limit of liability. The single loss limit applies to individual claims whereas the aggregate limit applies to the total of all loss recoverable under the bond. For example, if there is a $500,000 single loss limit and a $1,000,000 aggregate limit, payment of the single loss reduces available coverage for further losses during the bond period to $500,000. When the aggregate limit of liability is exhausted, the bond automatically terminates regardless of the remaining term and without any refund of premium. In order to determine the remaining insurance coverage, the amounts of all prior and pending claims against the bond should be deducted from the stated aggregate limit.

Scope of Blanket Bond Coverage

Clause (A) - Fidelity: Covers losses as a result of dishonest or fraudulent acts by the bank's officers and employees, attorneys retained by the bank, and nonemployee data processors while performing services for the insured. "Dishonest or fraudulent acts" are defined as acts committed by such employee with the manifest intent to cause the insured to sustain such loss and obtain financial benefit for the employee or another party (other than salaries or other employee benefits earned in the normal course of employment). Coverage of losses resulting from loan activity is severely restricted. Such losses are covered only if the employee involved acts in collusion with another party to the transaction and the employee receives a financial benefit of at least $2,500.

Clause (B) - On Premises: Loss of property (as defined in the bond) resulting directly from (a) robbery, burglary, misplacement, mysterious unexplainable disappearance and damage thereto or destruction thereof, or (b) theft, false pretenses, common law or statutory larceny, committed by a person present in an office or on the premises of the insured, while the property is lodged or deposited within offices or premises located anywhere. This clause does not provide for loss of property in the possession of any customer unless the bank is shown legally liable. Standard Form No. 5 covers loss of property in possession of customers (whether or not the insured is legally liable) while conducting business during regular business hours.

Clause (c) - In Transit: Identical coverage as that provided in Clause (B), except that the property is covered while in transit. The property must be in the custody of a person acting as a messenger of the bank, while the property is in transit anywhere.

Clause (D) - Forgery or Alteration: Optional coverage for loss through forgery or alteration of, on, or in checks, drafts, acceptances, and other instruments, as specified, which are received by bank either over-the- counter or through clearings. Items received as a transmission through an electronic funds transfer system are not covered.

Clause (E) - Securities: Optional coverage for loss resulting from the insured having, in good faith, for its own account or for the account of others, acquired, sold or delivered, or given value, extended credit or assumed liability, on the faith of, or otherwise acted upon, any original security, title document or agreement (as delineated in the bond), including coverage of U.S. Savings bonds.

Clause (F) - Counterfeit Currency: Covers loss resulting from the receipt by the insured in good faith, any counterfeit or altered money of the United States or Canada or any foreign country in which the insured maintains a branch office.

Factors to Consider in Determining Adequate Amount of Blanket Bond Insurance

The most difficult insurance problem confronting bank management is determination of the amount of blanket bond coverage that should be maintained. While an estimate of money and securities which might be lost through burglary or robbery can be fairly accurately calculated, there are no ready measures for potential losses from employee dishonesty.

The problems of determining an adequate amount of insurance coverage to indemnify for losses from external hazards is not a complex problem. Fairly accurate estimates can be made of the total values at risk, and the average amounts exposed during business hours are ascertainable. The various types and amounts of transactions should also be appraised. It may be prudent to reduce the insurance coverage for forged securities (Clause E) taken as collateral for a loan to the amount of the in-house bank lending limit. If that limit is never exceeded, the bank would not suffer a loss greater than that limit on any given transaction.

Determining an adequate amount of fidelity insurance on the bank's own personnel is a more difficult task that cannot be based solely on one precise factor. It requires the use of management and examiner judgment. Banking associations or the insurance industry may periodically develop schedules indicating the range of blanket bond coverage carried by banks grouped by deposit size. However, a bank's level of risk exposure is influenced by many variables, only one of which is deposit size. Therefore, an overall assessment of the effectiveness of the bank's internal operations must be considered. Other factors which may increase fidelity exposure and should be given consideration are: amount of cash and securities normally held by the bank; number of employees, experience, levels authority and turn-over rate in personnel; extent of trust or electronic data processing activities; and rapidly expanding operations. When the bank is a member of a holding company or other group of affiliated banks, one fidelity bond is usually purchased to cover the parent and all affiliated banks.

Basis for Claims Under the Bankers Blanket Bond

It is standard procedure for insurance companies to write blanket bonds on a "discovery" basis. Under this method, the insurance company is liable up to the full amount of the policy for losses covered by the terms of the bond and discovered while the bond is in force, regardless of the date on which the loss was actually sustained by the bank. This applies even though lower coverage amounts or more restrictive terms might have been in effect on the date the loss was sustained.

Alternatively, bonds may be written on a "loss-sustained" basis. This means the bonding company is liable only to the extent of the coverage for losses sustained during the period the bond is in force. Situations which prompt an insurer to only write a blanket bond on a loss-sustained basis may arise from another insurer having canceled or refused to renew a bank's bond (insurer not willing to assume the risk of any undiscovered losses which may have occurred while the bank was insured by another company); the loss record of the bank; poor internal controls; or uncertainty concerning management's abilities.

Blanket bonds require that a loss be reported to the bonding company within 30 days after discovery. Failure to file a report once management is aware of discovery, even if there is uncertainty as to reportability, could jeopardize coverage for that loss. In addition, coverage as to any employee automatically cancels as soon as the bank has knowledge of any dishonest or fraudulent act on the part of an employee. Coverage on such employee can only be assured by written affirmation of this insurer.

Banks must also notify the underwriter within 30 days of receiving any notice of legal action being brought against it which could result in a claim under the bond. The underwriter may elect, at its option, to defend the insured. If timely notice is not given by the bank or if the underwriter elects not to defend the action, the underwriter is not liable for attorneys' fees and court costs, nor does any judgment against the bank determine the existence of bond coverage.

The general agreements to Standard Form 24 make the application for insurance coverage part of the bond. Any misrepresentation, omission, concealment or incorrect statement in the application may be grounds for recession of the bond. Due to this strong language in favor of bonding companies, banks must be absolutely truthful, accurate and thorough in responding to questions on bond applications and questionnaires. There may be instances when it is appropriate for examiners to review such applications and questionnaires for accuracy and completeness.

Under the present Standard Form No. 24, there are no rights of any parties to make claims under the bond after the termination or cancellation of the bond. Banks may no longer purchase the right to extend the discovery period. It is therefore vitally important for banks to make immediate notification to the underwriter upon discovery of loss covered by the terms of the bond. If there is any uncertainty in this regard, the matter should be investigated promptly to determine whether a loss has in fact occurred that is covered by the terms of the bond. **Moreover, the results of any such investigation should be documented as the investigation proceeds. There is immediate termination of the bond upon the taking over of the insured by a receiver or other liquidator or by State or Federal officials. The FDIC is thus effectively barred from pursuing any claims against the bonding company which were not discovered by the bank prior to its closing.**

It is critical that the examiner in a potential closing situation call to the attention of the bank's board of directors all known facts concerning any loss discovered during the examination, and the bond requirements that notice be given to the bonding company within 30 days of discovery.

Electronic Data Processing Coverage

Briefly, such coverage is provided in the bond for serviced banks under the definition of "employee" which is defined to mean each natural person, partnership, or corporation authorized by the insured to perform services as data processor of checks or other accounting records of the insured. Usually the only riders for EDP coverage are those to eliminate it from the policy, which is not advisable. To further protect banks with EFTS systems and those with in- house computers that contract with outside programmers, additional coverage may be obtained by a rider or separate policy referred to as computer/computer related theft insurance. Usual coverage protects banks from criminal acts affecting data processing equipment, communication lines, data elements and program logic located in one or more of the insured's offices, at contract service bureaus (including financial institutions), and at automated clearing houses, switches or other electronic communications systems. For more detailed coverage of EDP insurance, refer to the FFIEC EDP manual.

Blanket Bond Riders

Numerous riders are available to delete coverage or cover risks not included in the basis blanket bond, or a separate policy may be obtained. All

riders should be carefully reviewed since additions and deletions to the basic policy can have significant impact.

Deductible and Self-Insurance Riders - Banks and insurance companies frequently use deductible clauses to fit the blanket bond coverage to a particular bank. The deductible amount generally ranges from $1,000 to $100,000, or higher, and is directly related to the willingness and ability of the bank to absorb risks. A bank with a history of few claims may choose to lower its premium costs by requesting a deductible clause on its blanket bond policy. On the other hand, a bank with a history of numerous losses may be required to utilize a deductible clause as a condition for continued blanket bond coverage. The use of deductibles obviously lowers the cost of insurance.

Automated Teller Machine Riders - Covers loss involving automated mechanical devices for disbursing money, accepting deposits, cashing checks or making credit card loans when such devices are not located within an office of the insured, and not permanently staffed with a bank teller.

Kidnaping and Extortion Rider - Covers losses arising from any of the various forms of extortion whereby the physical well-being of a person(s) is or is believed to be imperiled.

Computer Systems Rider - Covers losses resulting form the fraudulent entry of data or from the change of data or programs within a computer system.

Excess Employee Fidelity Coverage

The purpose of such coverage is to extend the basic protection provided under the blanket bond in areas where the dollar volume of assets of exposure is particularly high. Such excess coverage usually is written in multiples of $1 million and either carries a deductible clause equal to the amount of the blanket bond (usually requires primary bond coverage of at least $250,000), or states that coverage will be provided for the full amount of the excess policy when losses exceed a specified amount. Any deductible in excess of underlying primary coverage should be discussed with management. The most common form of this coverage is the Excess Bank Employee Dishonesty Blanket Bond, Standard Form No. 28. The FDIC strongly recommends that all banks acquire this modest cost protection against the possibility of catastrophic fidelity losses, unless the primary blanket bond coverage is sufficiently large enough to equal or exceed the protection provided by an excess fidelity bond.

Other Specialized Bank Insurance

This is not a comprehensive list of coverages available, but rather those frequently purchased.

Combination Safe Depository - Clause (A) covers losses when the bank is legally obligated to pay for loss (including damage or destruction) of a customer's property held in safe deposit boxes. Clause (B) covers loss, damage, or destruction of property in customer's safe deposit boxes, whether or not the bank is legally liable, when such loss results from other than employee dishonesty. The policy commonly provides for reimbursement of legal fees in conjunction with defending suits involving alleged loss of property from safe deposit boxes.

Registered Mail and Express Insurance - Insures valuable property such as money or securities shipped by registered mail, registered air mail, express, and air express. Coverage is provided from the time the property leaves the bank until delivered to the addressee.

Transit Cash Letter Insurance - Covers loss of cash letter items in transit for collection or to a clearing house of which the insured bank is a member. It also includes costs for reproducing cash letter items. Generally, such policies do not cover items sent by registered mail or air express, or losses due to dishonest acts of employees.

Valuable Papers and Destruction of Records Policy - Covers cost of reproducing records damaged or destroyed. It also provides the cost of research needed to develop the facts required to replace books of accounts and records.

III. OTHER DESIRABLE INSURANCE COVERAGE

The banking industry customarily utilizes forms of insurance for which the blanket bond, along with related policies, endorsements and special coverages previously noted, does not provide or provides insufficient protection. Banks may also need many of the same types of insurance required by any business or individual. The following are brief descriptions of some of those types of coverage.

Liability Insurance

Directors and Officers Liability - These policies provide for the indemnification of directors, officers and other employees against legal and other expenses incurred in defending lawsuits brought against them by reason of the performance of their official duties. They protect, under two insuring clauses, against the expense of defending suits alleging director or officer misconduct and against damages that may be awarded. One clause reimburses the bank for any payments made to directors or officers under an indemnification agreement with them. The other clause reimburses the directors or officers under an indemnification agreement. This coverage is written at a minimum of $1 million (deductible $10,000 to $20,000) with the insurance company paying a portion of any claim (usually 95%) over the deductible amount. This insurance does not cover criminal or dishonest acts, situations when the involved person obtained personal gain, or when a conflict of interest was apparent.

General Liability - Covers the bank from possible losses arising from a variety of occurrences. Typically, general liability insurance provides coverages against specified hazards, such as personal injury, medical payments, landlords' or garage owners' liability, or other specific risks that may result in or create exposure to a suit for damages against the bank. "Comprehensive" general liability insurance covers all risks, except specific exclusions.

Automobile Public Liability and Property Damage - Protects against property and liability losses arising from injury or death when a bank-owned, rented, or repossessed vehicle is involved. Non-ownership liability insurance should be considered if officers or employees use their own vehicles for bank business.

Umbrella Liability - Provides excess coverage over and above existing liability policies, as well as basic coverage for most known risks not covered by existing liability insurance.

Fixed Assets Physical Damage

Adequate insurance should be maintained to cover loss or damage of the bank's fixed assets.

Fire or Extended Coverage - This insurance covers all loss as a direct result of a fire including damage from smoke or water and chemicals used to extinguish the fire. Covering the building's contents for fire damage is additional, but often is written in combination with the policy on the building and permanent fixtures. Extended coverage indemnifies against losses from windstorm, hail, explosion, riot, civil commotion, aircraft, vehicles, and smoke damage. Usually not included is damage caused by rising water or malfunction of a steam boiler. Most fire insurance policies contain "coinsurance" clauses, meaning insurance coverage must be maintained at a fixed proportion of the replacement value of the building, usually 80%. If a bank fails to maintain the required relationship of protection, all losses will be reimbursed at the lower ratio of the amount of the insurance carried to the amount required, applied to the actual value of the building at the time of the loss. When determining insurable value for fire insurance purposes, the typical base is the cost of replacing the property with a similar kind or quality at the time of loss.

Boiler and Machinery - Provides coverage for loss due to explosion or other forms of destruction of boilers, heating and/or cooling systems, and similar types of equipment.

Fine Arts - Includes coverage for art objects on display whether owned by the bank or on loan from another source. Protection generally is all-risk and requires that an appraisal of the material be made regularly to establish its insurable value.

Extra Expense - Provides funds for the additional costs of reestablishing the bank's operations after fire or other catastrophe such as renting temporary quarters and/or equipment on an interim basis. Business Interruption - Provides reimbursement for the gross earnings lost when the bank cannot operate because of fire or other catastrophe, often with a coinsurance clause.

Rental Income - Rental insurance provides protection when a fire or other hazard renders the insured premises unfit for occupancy and a lessee ceases to pay rent. The policy will pay the building owner an amount equal to the reasonable rental income immediately before the loss, less any avoidable expenses.

Bank Owned/Leased Automobile - Standard coverage for accidental loss sustained through collision involving a bank automobile. Comprehensive coverage also is available for damage to an automobile other than through collision.

Lending Activities

Various types of insurance are available to cover certain risks in lending activities dependent upon what management considers necessary and warranted for the bank.

Mortgage Lending Activity

Mortgage Errors and Omissions - Protects the bank from loss when fire or all-risk insurance on real property held as collateral inadvertently has not been obtained or has expired. Generally, this insurance is not intended to overcome errors in judgment, such as inadequate coverage or insolvency of an original insurer.

Title Insurance - Insures marketability of title, access to the property, validity and enforcement of the mortgage and, subject to the stated exceptions, its priority. The policy also insures that the person to whom the bank is making the loan has title to the real estate pledged as security. Commitments for insurance are issued in advance of closing, outlining scope of the coverage, stating the specific exceptions from coverage and the standard exceptions.

Mortgagor's Defaults - Contract with a third-party mortgage insurer to absorb all or part of the risk that the value of the mortgaged property will not cover the loan and costs. Government agencies (FHA and VA) and private insurers provide mortgage protection coverage. This insurance is attractive to lenders who intend to sell mortgages in the secondary market.

Instalment Lending Activity

Single Interest - This insurance covers losses to uninsured vehicles pledged as collateral for an extension of credit.

Nonfiling Insurance - Covers losses resulting from nonfiling of liens or recording appropriate instruments on personal property pledged as collateral under chattel mortgages, conditional sales contracts and other similar instruments.

Credit Life, Accident and Health - These types of insurance are written in conjunction with an extension of credit, especially an instalment loan, and are designed to protect the bank against loss in the event of a debtor's inability to pay because of sickness, accident or death.

Fraudulent Accounts Receivable and Fraudulent Warehouse Receipts

Cover losses resulting from the pledging of fraudulent or nonexistent accounts receivable and warehouse receipts, or from situations in which the pledger does not have title. In addition, this insurance offers protection against loss arising from diversion of proceeds through acts of dishonesty.

Personnel Administration

Depending on the needs of an individual bank, there are various types of coverage that can be obtained to benefit employees or cover the loss of an employee.

Keyman Insurance

Insurance purchased by the bank for the benefit of the bank on the life of an officer when the death of such officer "keyman" would be of such consequences as to affect the operation of the bank. The term "keyman" is defined to mean any bank officer, regardless of title, who participates in major policy making functions of the bank and whose loss to the bank would be of consequence because of knowledge, experience and related qualifications. Many "keyman" insurance programs are designed to provide a fringe benefit to the insured officer and family. The benefit accrues to the officer when, upon death, the board of directors of the bank directs payment of the proceeds to the officer's family.

Employee Benefit Insurance

An employee benefit program, to be effective, must be able to respond to the changing needs of employees; be competitive with other firms in the trade area who employ individuals similarly qualified to those employed by the bank; be

within reason as to overall cost; and compare favorably to peer group statistics. Some insurance coverages are legally required programs such as unemployment insurance, workmen's compensation, and Social Security. Other commonly provided insurance policies are group insurance protection for life, health, accident, medical, hospitalization, vision, and dental. Other programs such as deferred compensation and salary continuance have been developed which provide additional fringe benefits to key officers and/or their designated beneficiaries. The premiums for such insurance are paid either in part or entirely by the bank, with the bank having no beneficial interest in the policy.